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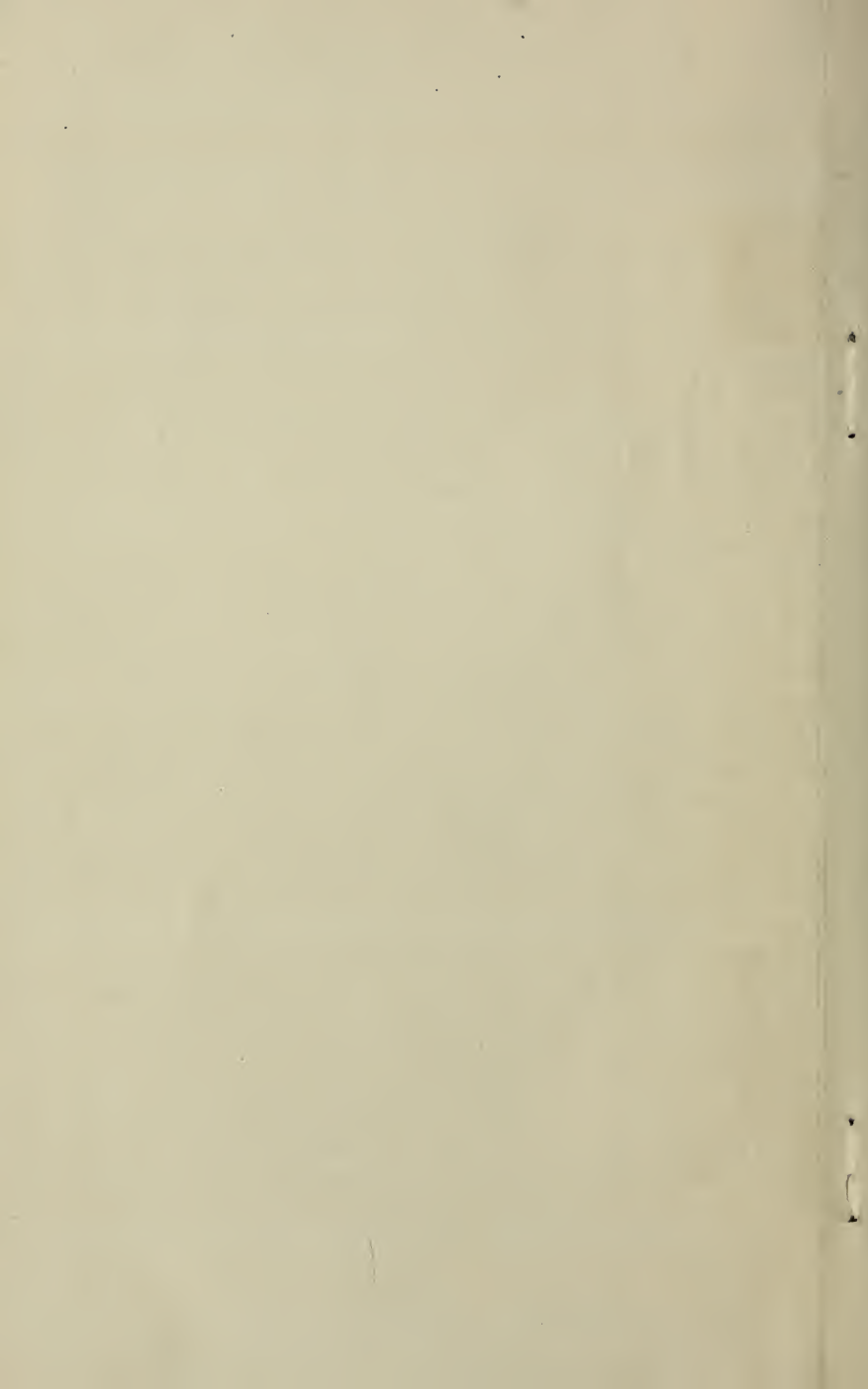
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THE EVILS *of* TAX EXEMPTION AS APPLIED TO SECURITIES

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The Evils of Tax Exemption as applied to Securities

By Kingman Nott Robins

THE scope of this paper is limited, not only by time but by the writer's approach to the subject as a business man without the background of information and study that belong to the tax expert.

It is not a new question we have to discuss, for the problem of tax exemptions is as old as taxation itself; but the subject has been brought to the fore in the last two years by the abrupt increase in taxes and the evident necessity for keeping the bases of our taxation as broad as possible and the incidence of our taxes as equitable and economically sound as possible.

The evil of tax exemption heretofore has been chiefly recognized in connection with the General Property Tax. 12 billions, or 12½% of the total real property of the United States, is estimated to be exempt. We have no similar figures for personalty, but it is calculated that the exemptions of personalty in New York State under the General Property Tax exceed the total assessed value of the realty in the State.

It is true, of course, that these exemptions of personalty are chiefly due to the practical impossibility and injustice of applying to personalty the same rate as to real estate and in the same proportion. But the fact remains that these exemptions, as we have had them for years, have resulted in gross inequality in tax incidence and in a steadily mounting tax burden on those already bearing more than their share of the load.

Even before we encountered the extraordinary expenses of the war period, it was becoming increasingly evident that the mounting cost of Government,—Federal, State, County and Municipal,—would compel taxation of personalty by some practical, approximately equitable method; and since, as Professor Bullock has said, "the normal source of taxation is, and always must be, income," the income tax has come to be looked upon as the most equitable and economically sound method of reaching those who have heretofore not been called on for their just share; at least if we calculate on the basis of "ability to pay."

This recognition of the Income Tax as an increasingly important factor in our scheme of taxation renders essential the preservation

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of as broad a basis as possible for this tax. To that end it is indispensable that exemptions be minimized from the outset. Without question, as the burden of the Income Tax becomes more and more felt, and its burden is regarded as a permanent one, there will be attempts to create exemptions not only for the benefit of special interests among the taxpayers, but even more for the benefit of special interests among borrowers on bonds and mortgages, who will hope to lower their interest charges by making their obligations free of tax.

Responsibility for protection from this abuse rests alike on national and local governments, but the Federal Government has been the outstanding offender to date, if we base on constitutional grounds only the enjoyment by State, County and Municipal obligations of exemption from the Federal Income Tax.

Apart from this constitutional question affecting only this class of obligations, exemption or non-exemption of securities issued by or under the auspices of federal and local governments is purely a matter of policy; and for that policy no argument except expediency—the anxiety to sell the securities—has ever been offered, and even the argument of expediency can be mathematically disproved. As before stated, the Federal Government has been the great offender. It might have been argued that during the war it was necessary to throw to the winds all considerations of economy and justice in order to float a forced loan, but surely no such excuse exists now, and no present emergency warrants such a policy, condemned by all economists and tax experts. And yet, the Federal Government is going right on exempting not only its own issues but a growing list of securities for which it acts as sponsor. Roughly speaking, the list of securities issued or sponsored by the Federal Government includes Government bonds, Federal Farm Loan bonds and Joint Stock Land Bank bonds, and War Finance Corporation bonds. If measures now pending in Congress become law, there will be added to these, Federal Home Loan bonds, Federal Personal Credit bonds and tax exempt real estate mortgages, as provided by Senator Calder's bill. Possibly, also, tax exemption is one of the arguments in the minds of those who favor Government sponsorship of railway securities and the obligations of other utilities. It is hard to say why the manufacturer and merchant should be left out of the consideration of these beneficently minded gentlemen.

It is quite true that, apart from the Liberty Bonds and Municipal Bonds, there is no great volume of these exempt securities outstanding; but since the pressure of the Income Tax has just begun to make itself

felt, we can safely assume that the menace of tax exemption should be regarded from the standpoint of potential rather than present scope.

With this viewpoint in mind, it is truly alarming to sum up the potentialities of existing and proposed partially and wholly exempt issues. The following figures are approximations:

Federal issues, already,		20 billions
Municipal and State issues,		4 billions
Already outstanding		24 billions
Federal Farm Loan and Joint Stock Land		
Bank Bonds, outstanding and to be		
issued if they supplant present private		
loans,		4 billions
Federal Home Loan Bonds,		2 billions
War Finance Corporation, authorized,		1½ billion

In this list no mention is made of the great volume of tax exempt mortgages that the passage of Senator Calder's bill would create, nor of the tax exempt issues proposed for the Federal Personal Credit Banks; but the list already includes over 30 billions of partially or wholly non-taxable bonds, and that is equivalent to approximately 40% of the entire national wealth, apart from real estate, in the year 1912.

The potentialities of this huge list are accentuated by the progressive increase in federal and local indebtedness, which is growing so much more rapidly than the national wealth and is thus creating tax exempt securities bearing an increasing ratio to the wealth of the country and thus steadily undermining the foundations of the Income Tax. The debt of the United States Government has, of course, inevitably grown disproportionately because of war expenses, the increase being 25 billions in six years. This makes the annual interest burden alone equal to the total revenue of the Government in the last pre-war year, and equal to 20% of the estimated annual increase in national wealth. It is obvious that the Federal Government, with the necessity of not only paying interest on but of amortizing such a debt, and with a vast extension of its governmental powers to provide for, will have to maintain the Income Tax rates at high levels.

The debt of the local governments,—State, County, City and Rural,—increased 113.2% in the decade 1902—1913, as compared with an increase in national wealth for the same decade of only 75%. In other words, the tax exempt securities of these governments are

not only rapidly increasing but are increasing out of all proportion to the increase of national wealth.

In contrast to this factor in the undermining of the foundations of the Income Tax, we find the states rapidly adopting their own income taxes to help carry the burden of annual expenses which increased 105.9% in the decade of 1903 to 1913.

Thus we are confronted with a rapidly increasing need for revenue from the Income Tax, combined with a still more rapid increase in securities, the income on which is non-taxable. Two questions arise:

1. What will happen to the revenue producing capacity of the Income Tax?
2. What will happen to those who must seek money in the market in competition with these tax exempt securities?

The answers seem as obvious as the questions:—

1. That the basis of taxation will be continuously and progressively narrowed down by the displacement of taxable securities by non-taxable securities in the hands of investors, and that the rates of taxation will have to be maintained at uneconomic levels to yield the required revenue.

2. That the private corporation or individual seeking accomodation in the investment market will be at an increasing disadvantage, and will quite probably be forced to go out of business.

In appraising the probability of these results, it should be borne in mind that we have had only two years of coexistent high income taxation and tax exempt securities, and the effect of the shifting process which must result will be progressive and has been obscured up to this time by the abnormal effect of the war on enterprise and the investment market.

This shifting process is now making itself felt, which accounts for the widespread clamor for Government relief and the privilege of tax exemption which we have described. If this privilege has been given the farmer under the Federal Farm Loan Act, why not to us, is the natural question of every other class in the community.

To illustrate the condition already confronting us, as a result of this policy of exemptions, I quote from the testimony before the New York State Reconstruction Commission of Mr. Clarence H. Kelsey, President of the Title Guarantee and Trust Company of New York:—
“What we are trying to do is to get you and Congress to make it worth while for private capital to finance building operations. Unless you make it worth while, capital won’t do it.” * * * * * “Investors are running away from mortgages and will continue to do so, (because)

Government bonds just issued paying $4\frac{3}{4}\%$, and exempt, yield a larger return than a 5 and $5\frac{1}{2}\%$ mortgage." As a result of this and other similar testimony, Senator Calder of New York introduced his bill exempting from taxation mortgages up to \$40,000.

This action, of course, can be only the beginning of similar relief measures for other classes of borrowers, and we face the clear cut issue:—Shall we nullify the income tax by this indefinite increase of tax exemptions, or shall we eliminate them altogether in all subsequent issues of the Federal Government, the Federal and Joint Stock Land Banks, the War Finance Corporation, etc.?

Economists and tax experts seem to be unanimous in their declaration against tax exemption, and their answer to the foregoing question would, therefore, seem obvious. Perhaps, for that reason, it will be an imposition to repeat here the arguments against the policy of exemptions, especially as applied by the Federal Government to its own issues and those for which it is sponsor. Nevertheless, I ask your permission to summarize them as follows:

1. Tax exemption is *unscientific* because it defeats its own end and nullifies the taxing power of the state. It destroys the equitable working of a graduated income tax, which has come to be generally recognized as the most equitable of all taxation in its incidence, for the reason that those required by the Income Tax Act to pay the heaviest rates are the most likely to escape taxation entirely by investing their funds in tax exempt securities.

The appeal of the tax exempt security to investors increases in proportion to their tax burdens:—the greater the burden, the greater the appeal. Inevitably the market price for tax exempt securities is fixed by the demand for them by those investors who, by owning them, can escape the heaviest tax burdens. This market price fixed by these investors is too high to attract other investors, with the result that the ownership of tax exempt securities concentrates in the hands of those who would otherwise pay the heaviest taxes.

2. Tax exemption is *inexpedient* and *costly* to the state because it shifts the burden from the shoulders of those best able to bear it, and in so doing deprives the state of revenue several times as great as the saving in interest which the tax exemption privilege confers on its beneficiaries.

If the facts supported the contention made in some quarters, that what is lost in taxes is made up by the saving in the amount of the rate of interest paid by the borrower, the price for tax exempt bonds and taxable bonds, other things being equal, would vary in direct

ratio to this apparent saving. It is obvious, from a study of market prices of such securities, however, that this is not the case. At the present market, the spread in yield between the totally tax exempt First Liberty Loan and the non-exempt issues is less than one per cent, whereas the saving in taxes to recipients of incomes in the upper brackets under the present Revenue Law amounts to at least two-thirds of the total return on the taxable bonds. In other words, they get as much net return from the $3\frac{1}{2}\%$ totally tax exempt bonds as they would from the taxable bonds yielding from 10 to 12%.

To further illustrate this tax exemption loss to the state, we find that the spread in yield at the present market between the totally tax exempt 5% Federal Farm Loan bonds and similar securities not subsidized by the Federal Government by the privilege of tax exemption varies from one-half of one per cent to one per cent, whereas the recipient of an income in the higher brackets of the present law derives a net return from these Federal Farm Loan bonds as high as he would on taxable securities yielding 12%, 15% and more.

Obviously, the state would save money were it to grant a direct cash subsidy to its beneficiaries under the Federal Farm Loan System, instead of granting this indirect subsidy of tax exemption, which is from four to seven times as great as the cash equivalent of the saving in interest enjoyed by the borrowers under this System. The argument for tax exemption on the ground of expediency, therefore, seems transparently false.

3. Tax exemption is a *dangerous policy* from the standpoint of both economic and social statesmanship, because it fosters government monopoly by putting private enterprise at a constant disadvantage. Tax exemption, when granted to beneficiaries of the Government through the agency of institutions sponsored by the Government, such as the Federal Farm Loan Banks and the proposed Federal Home Loan Banks, is clearly in contravention of the Constitution because it is a subsidy with special privilege to a class in the community. Even if it were constitutional, the danger would remain for the reason that these institutions, by offering this subsidy, are in a position to force out of competition with them all private institutions not equally favored. Even though private agencies might be much more economical and efficient in operation, these advantages would not offset the subsidy enjoyed by the Government sponsored institutions and, potentially at least, the Government would monopolize the field.

Tax exemption, as we find it in this country at the present time, both in practice and proposed, is one of the most powerful and in-

sidious forces now making for state control of banking and industry. In this connection, it is interesting to observe that in the countries where state socialism has made the greatest progress, control of the banking resources has been one of the first and most potent weapons in the hands of the state socialists. Our own Federal Government, by granting the subsidy and special privilege of tax exemption only to itself and to institutions under its control, has the power to completely monopolize the financing of the country.

There is an interesting confirmation of this argument in the fact that those responsible for the operation of the Federal Farm Loan Banks contend that without this privilege of tax exemption, the System could not succeed, and they are the most bitterly opposed to the movement to remove the tax exemption privilege. The natural conclusion from this opposition would be that if the Federal institutions were placed on an even plane with the private institutions, they would not be able to compete either in efficiency or rates. As a matter of public policy, it would seem obviously wise to put these public agencies on an equal plane with private institutions, so that both might be compared on their merits. It seems equally unwise to saddle the country with a system of Government controlled institutions which are able to monopolize the business only because of the special privilege which they enjoy and which, without this privilege, would not be able to continue business.

What has been said of the Federal Farm Loan Banks is equally true of the Federal Home Loan Banks, the Personal Credit Banks and other Government controlled and subsidized institutions which are proposed in impending measures.

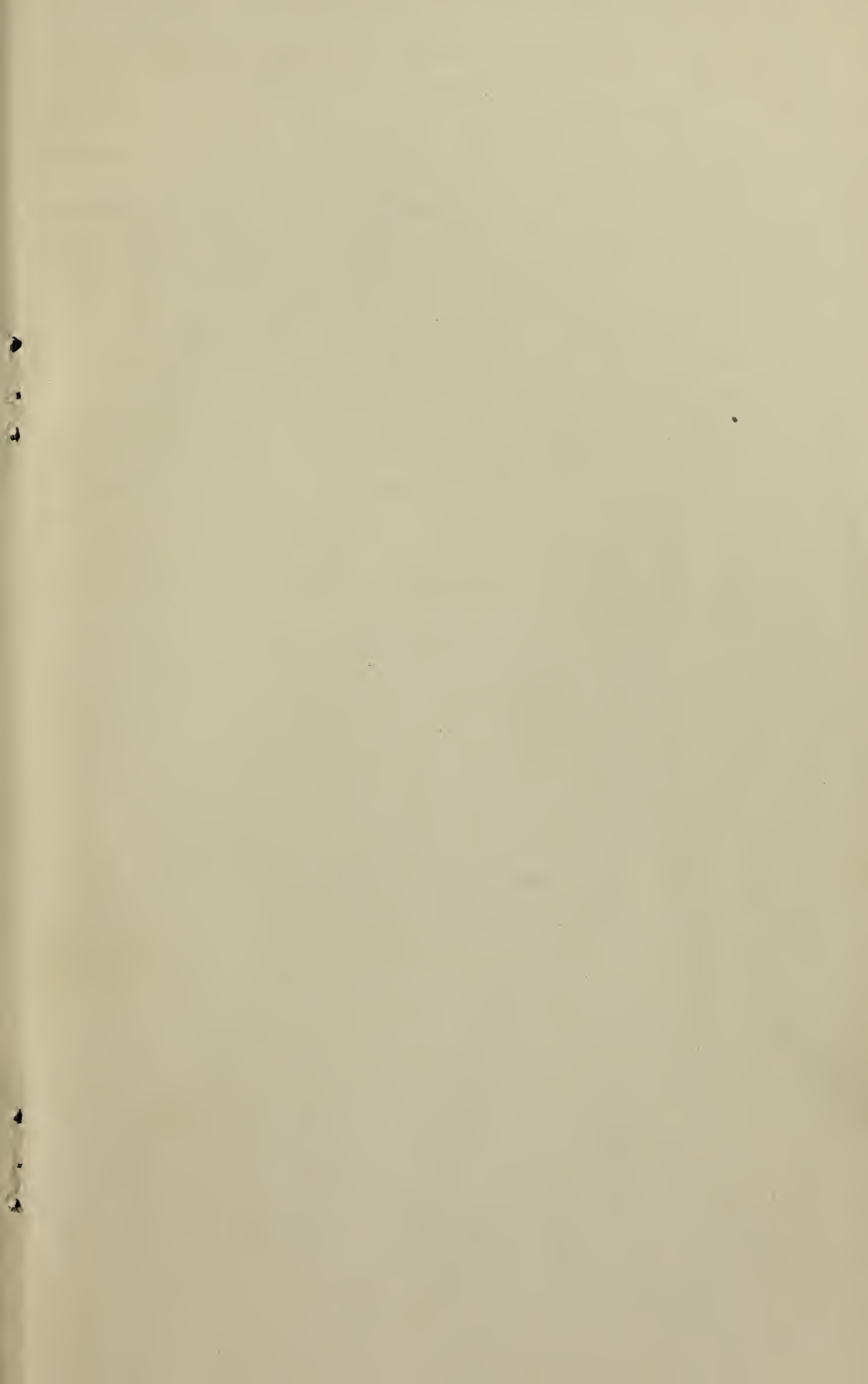
4. Tax exemption is *virtually impossible* because it involves burning the candle at both ends and, by constantly narrowing the basis of taxes and correspondingly raising the rates, finally extinguishes the tax-paying power of the community. Obviously, the exemption from taxation of certain classes of securities naturally leads to the exemption of others until, when all securities were tax exempt, we would again be reduced to real estate as the only basis of taxation, except for taxes on service incomes and consumption taxes. This enforced single tax on real estate would unquestionably result in the extinguishment of the tax-paying power of real estate, *Reductio ad absurdum*.

It seems superfluous to re-enforce these arguments in order to arrive at a conclusion that the only sane course is for the Federal Government to remove all exemptions from all future issues of its own and other institutions for which it is responsible.

If this Association concurs in this conclusion, it might well pass resolutions supporting the statement on the subject contained on Page 14 of the Report of the Committee to Recommend a Model Plan for State and Local Taxation, prepared for the Conference planned for November 12-15, 1918, as follows:

"We are aware that, under the unreasonable and unworkable requirements of the general property tax, it has appeared desirable in times past to exempt State and local bonds from taxation, to exempt real estate mortgages and to grant various other exemptions. All such exemptions are inconsistent with the theory of the tax we here propose, and should be discontinued as rapidly as the circumstances of each case permit.

The personal obligation of the citizen to contribute to the support of the Government under which he lives should not be affected by the form his investments take, and to exempt any form of investment can only bring about an unequal and therefore an unjust distribution of this tax. Our reasoning applies, of course, to the exemption which agencies of the Federal Government now enjoy."



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